



“RED FLAGS”
(POSSIBLE INDICATORS OF FRAUD)

Provided
By
The Office of the Georgia State Inspector General

Produced In Cooperation With:
The Institute of Internal Auditors,
The Association of Certified Fraud Examiners
The University of Louisiana

RED FLAG WARNINGS OF FRAUD

Red flags are certain conditions or symptoms that may indicate either an elevated potential for fraud or the actual presence of fraudulent activity. Becoming aware of these conditions or symptoms (i.e. red flags) can be a very useful tool, if used properly. While the presence of the conditions or symptoms indicated below does not guarantee that fraud exists, they do indicate a higher likelihood of occurrence. Each agency should learn to identify the red flags and, where possible, seek to eliminate the causes.

CAUTION

The symptoms may be present, when fraud actually isn't. Therefore, one should avoid jumping to conclusions.

PERSONAL CHARACTERISTICS THAT MAY LEAD TO FRAUD

PERSONAL AND PSYCHOLOGICAL CHARACTERISTICS THAT SUGGEST AN INCREASED POTENTIAL FOR FRAUD ARE:

- 1) Low moral character
- 2) Rationalization of contradictory behavior
- 3) A lack of a strong code of ethics
- 4) Wheeler-dealer attitude
- 5) Lack of stability (associated with promotional stagnation, career plateauing, aging, or domestic incompatibility)
- 6) A strong desire to beat the system
- 7) Employee believes that job is in jeopardy
- 8) Employee has a criminal record
- 9) Employee has an outside business interest
- 10) Employee is overly defensive
- 11) Employee is overly secretive
- 12) Employee living beyond his or her means
- 13) Employee refuses to take a vacation
- 14) Employee turns down promotions or transfers
- 15) Excessive family or peer pressure to succeed
- 16) Excessive overtime
- 17) Feelings of being unappreciated
- 18) Feelings of being underpaid
- 19) Feelings of grandeur or superiority, i.e. personal challenge to beat the system
- 20) Feelings of insufficient recognition for job performance
- 21) Gambling problems
- 22) Lack of personal stability, such as frequent job changes, residence changes, etc.
- 23) Large personal financial losses
- 24) Marked change in employee's personality
- 25) Marked change in employee's spending habits
- 26) Poor credit rating
- 27) Pressures associated with family illness
- 28) Unemployment of other family members

- 29) Unusually high personal debt
- 30) Unreliable communications and reports
- 31) Overtime during slack periods

PERSONAL SITUATIONAL PRESSURES THAT CAN LEAD TO FRAUD

PERSONAL FINANCIAL FACTORS THAT CAN LEAD TO FRAUD ARE:

- 1) High personal debt
- 2) Significant personal losses
- 3) Inadequate income
- 4) Living beyond one's means
- 5) Illness/Extensive medical needs

PERSONAL HABITS THAT CAN LEAD TO FRAUD ARE:

- 1) Extensive stock market or other types of speculation
- 2) Extensive gambling
- 3) Illicit sexual involvement
- 4) Heavy use of alcohol or drugs
- 5) Routine borrowing

PERSONAL FEELINGS THAT CAN LEAD TO FRAUD ARE:

- 1) Extreme community or social expectations to succeed
- 2) Perception of being treated unfairly or inadequately by organization
- 3) Resentment of superiors
- 4) Frustration with the job
- 5) Peer-group pressures within the company
- 6) Personal/family expectations that cannot be met
- 7) Insatiable desire for self-enrichment or personal gain
- 8) Employee believes that job is in jeopardy

OPPORTUNITIES THAT CAN LEAD TO FRAUD

PERSONALLY CREATED OPPORTUNITIES THAT CAN MAKE FRAUD EASIER ARE:

- 1) Familiarity with operations (including cover-up capabilities)
- 2) Close association with suppliers and other key people
- 3) Close association with customers

BUSINESS CONDITIONS THAT MAY INDICATE POSSIBLE FRAUD

- 1) Increase in scrap materials and reorders for same items
- 2) Invoices that are duplicates or copies
- 3) Large number of write-offs
- 4) Missing files
- 5) Missing supporting documentation
- 6) No separation of custody of assets from transaction authority
- 7) No separation of the custody of assets from the accounting of those assets
- 8) Reluctance to provide information to auditors
- 9) Rising or sharp increase in departmental expenses
- 10) Shortages in inventory
- 11) Shortages or overages in cash drawers

- 12) Employees and others complaining that, "I didn't receive my check"
- 13) Employees and others complaining that, "I paid this"
- 14) Sudden activity in a dormant banking account
- 15) The presence of copies where originals are expected
- 16) Unauthorized bank account in the agencies name
- 17) Unrecorded transactions
- 18) Unusual transactions
- 19) Vendors without physical address listed

AGENCY CHARACTERISTICS THAT MAKE IT EASIER FOR AN INDIVIDUAL TO COMMIT FRAUD ARE:

- 1) Failure to inform employees about rules and disciplines of fraud perpetrators
- 2) Rapid turnover of key employees
- 3) Absence of mandatory vacations
- 4) Absence of periodic rotations or transfers of employees
- 5) Inadequate personnel screening policies for hiring new employees
- 6) Absence of explicit and uniform personnel policies
- 7) Failure to maintain accurate personnel records for disciplinary actions
- 8) Failure to require executive disclosures
- 9) Dishonest or unethical management
- 10) Dominant top management
- 11) Constantly operating under crisis conditions
- 12) Paying little attention to details
- 13) Impersonal relationships or poor morale
- 14) Lack of internal security
- 15) Inadequate physical security
- 16) Too much trust/confidence placed in key employees
- 17) Too much control in the hands of a few key employees
- 18) Tenure on key jobs becomes too long
- 19) Books and record keeping are sloppy
- 18) An agency that does not enforce clear lines of authority and responsibility
- 19) An agency that does not enforce proper procedures for authorizations of transactions
- 20) An agency that is not frequently reviewed by external auditors
- 21) An agency that is not frequently reviewed by internal auditors
- 22) An agency that lacks adequate documents and records
- 23) An agency that lacks competent personnel
- 24) Computer usage and applications are only loosely controlled
- 25) Failure to discipline violators of organizational policies, i.e. violator may be holding fraud over the perpetrator's head
- 26) Failure to take action on the results of internal / external audits or reviews
- 27) Frequent changes in checking accounts
- 28) Goods purchased in excess of need
- 29) Ignored employee complaints concerning possible fraud
- 30) Inadequate staffing

SITUATIONAL PRESSURES THAT CONTRIBUTE TO MANAGEMENT FRAUD:

AGENCY FINANCIAL PRESSURES THAT CAN LEAD TO FRAUD ARE:

- 1) Heavy investments or losses
- 2) Insufficient working capital
- 3) Unusually high debt
- 4) Reduced ability to acquire credit
- 5) Profit squeeze
- 6) Restrictive loan agreements
- 7) Progressive deterioration in quality of earnings
- 8) Urgent need for favorable earnings
- 9) Need to gloss over temporarily bad situations.
- 10) Unmarketable collateral

AGENCY LIMITATIONS THAT CAN LEAD TO FRAUD ARE:

- 1) Dependence upon only one or two products
- 2) Dependence upon only one or two customers
- 3) Excess capacity
- 4) Severe obsolescence
- 5) Extremely long cycle times
- 6) Existence of revocable or imperiled licenses

BUSINESS DECISIONS THAT CAN LEAD TO FRAUD ARE:

- 1) Extremely rapid expansion
- 2) Publishing of overly optimistic earnings/accomplishments forecasts

EXTERNAL ECONOMIC CONDITIONS THAT CAN LEAD TO FRAUD ARE:

- 1) Unfavorable economic conditions within government
- 2) Difficulty in collecting receivables
- 3) Unusually heavy competition
- 4) Significant reduction in sales backlog
- 5) Pressure to merge/consolidate
- 6) Sizable inventory increase without a comparable sales increase

LEGAL DIFFICULTIES THAT CAN LEAD TO FRAUD ARE:

- 1) Significant tax adjustments
- 2) Significant litigation, especially between customers and management
- 3) Potential suspension of activities

OPPORTUNITIES THAT ALLOW OR ENCOURAGE MANAGEMENT FRAUD

RELATIONSHIPS WITH OUTSIDE PARTIES THAT MAKE FRAUD EASIER TO COMMIT ARE:

- 1) Related-party transactions
- 2) Use of several different auditing firms/agencies
- 3) Reluctance to give auditors needed data
- 4) Use of several different legal firms or the frequent changing of legal counsels
- 5) Use of a large number of banks/accounts
- 6) Continuous problems with regulatory agencies

ORGANIZATIONAL STRUCTURES THAT MAKE FRAUD EASIER:

- 1) Complex business structures
- 2) Ineffective or nonexistent internal auditing staff
- 3) High level of computerization in an agency

- 4) Inadequate internal controls
- 5) Rapid turnover of key employees

AN ECONOMIC ENVIRONMENT THAT MAKES FRAUD EASIER TO COMMIT IS:

- 1) An agency with oversight of: large budgets, licensing, grant money, cash money, contracts, extensive purchasing authority
- 2) Excessive number of checking accounts

ACCOUNTING PRACTICES THAT MAKE FRAUD EASIER TO COMMIT ARE:

- 1) Large year-end or unusual transactions, use it or lose it purchases
- 2) Unduly liberal accounting practices
- 3) Poor accounting records
- 4) Inadequate staffing in the accounting department
- 5) Inadequate disclosure of questionable or unusual accounting practices
- 6) Excessive voids or refunds

UNUSUAL BUSINESS RELATED ACTIONS

QUESTIONABLE ADMINISTRATIVE ACTIONS

- 1) Activation of a dormant account, followed by a payment
- 2) Address changes followed by a request for payment
- 3) Adjustment of financial entries that lack formal approval
- 4) Alteration of final documents
- 5) Bank statements not reconciled or done so in an untimely manner
- 6) Changes in logs, payroll certification documents, etc.
- 7) Checks that have second endorsements

- 1) **NOTE:** The above red flags came from a variety of sources. These sources include the Institute of Internal Auditors, the Association of Certified Fraud Examiners and the University of Louisiana.